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SUMMARY OF SELECTED PROVISIONS OF THE SMALL BUSINESS JOB PROTECTION ACT

(Pub. L. 104-188, signed August 20, 1996)

— by Neil E. Harl*

Expense Method Depreciation

The amount of expense method depreciation has been increased from its 1996 level of \$17,500 as follows:

1997	\$18,000
1998	18,500
1999	19,000
2000	20,000
2001 and 2002	24,000
After 2002	25,000

Act § 1111(a), amending I.R.C. § 179(b)

The legislation does not alter what is eligible for expense method depreciation except as noted in the next item.

Expensing Denied

The legislation denies expense method depreciation for property used outside the United States, property used in connection with furnishing lodging, property used by tax-exempt organizations, property used by governments and foreign persons and air conditioning and heating units. **Act § 1702(h)(19), amending I.R.C. § 179(d)(l).**

The provision is effective for property placed in service after December 31, 1990. **Act § 1702.**

"Aggie" Bonds

The legislation has eased the eligibility requirements for tax-exempt First-Time Farmer Industrial Development Bonds issued by state and local governments. Funds from the bonds may be used to finance a "first-time farmer's" purchase of land and personal property used in farming operations. The amount of farmland that an individual may own and still be considered a first-time farmer has been doubled from 15 percent to 30 percent of the median size farm in the county in which the land is located. Also, proceeds from the tax-exempt bonds may now be used to finance farm purchases (land or personal property) from related parties. Related party acquisitions must be for fair market value and, after the acquisition, the related person must not have a financial interest in the farming operation with respect to which the bond proceeds are to be used. The change will allow children to buy land from parents or other close relatives and still be eligible for financing under the

beginning farmer loan program.

The Conference Committee report states that a seller will not be treated as having a financial interest in the farming operation if the seller--

"(a) has no more than a ten-percent interest in the capital or profits in a partnership comprising the farm;

"(b) has no more than a ten-percent stock interest in a corporation comprising the farm;

"(c) has no more ten-percent [sic] of the beneficial interest in a trust comprising the farm;

"(d) is not a principal user of the farm; or

"(e) has no other direct or indirect ownership or use of the farm which has as a principal purposes [sic] the avoidance of this provision."

Act § 1117(a), amending I.R.C. § 147(c)(2).

The provision is effective after the date of enactment of the act.

Dues For Agricultural or Horticultural Organizations

Dues paid up to \$100 per year are not to be considered unrelated business income for agricultural or horticultural organizations. **Act § 1115, adding I.R.C. § 512(d).**

The provision is effective for taxable years beginning after December 31, 1986. **Act § 1115(b).**

Involuntary Conversions

If property held for productive use in a trade or business or for investment is involuntarily converted as a result of a Presidentially-declared disaster after 1994, the proceeds can be reinvested in any tangible property held for productive use in a trade or business. **Act § 1119, amending I.R.C. § 1033(h).**

The provision is effective for disasters for which a Presidential declaration is made after December 31, 1994, in tax years ending after that date. **Act § 1119.**

Lease Improvements

The legislation clarifies that the lessor's unrecovered cost for leasehold improvements made by the lessor for the lessee and disposed of or abandoned upon the expiration of the lease is to be treated as though the property was disposed of by the lessor. Thus, the remaining basis may be recovered even if there is no actual disposition of the underlying property. **Act § 1121(a), amending I.R.C. § 168(i).**

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The Conference Committee report specifies that the provision does not apply to the extent the present-law demolition rules apply under I.R.C. § 280B.

The provision is effective for leasehold improvements disposed of or abandoned after June 12, 1996. **Act § 1121(b).**

S Corporations

Number of shareholders. For tax years beginning after December 31, 1996, the maximum number of shareholders in an S corporation is increased from 35 to 75. **Act § 1301, amending I.R.C. § 1361(b)(1)(A).**

New category of trust. The legislation creates a new category of trust eligible to hold stock in S corporations, known as a "small business trust." In such trusts, each potential current beneficiary is treated as a shareholder.

To be a small business trust, only individuals, estates and certain charitable organizations which hold a contingent interest and are not a potential current beneficiary can be beneficiaries; no interest in the trust can be acquired by purchase (interests in small business trusts must be acquired by gift, bequest or other non-purchase acquisition); and an election must be made. Qualified Subchapter S trusts and tax exempt trusts are not eligible to be small business trusts. Each potential current beneficiary is treated as a shareholder for purposes of the 75-shareholder limitation.

The portion of the trust consisting of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. This portion of the trust's income is taxed at the highest rates imposed on estates and trusts. The taxable income that is attributed to the trust as an S corporation shareholder includes (1) gain or loss from the sale of the S corporation stock; (2) items of income, loss or deduction allocated to the trust as an S corporation shareholder under the subchapter S rules; and (3) any state or local taxes and administrative expenses of the trust allocable to the S corporation stock. **Act § 1302, amending I.R.C. § 1361(c)(2)(A).**

The provision is effective for taxable years beginning after December 31, 1996.

Trust ownership of stock after death. The legislation changes the 60 day post-death holding period, for trusts holding S corporation stock, to two years, effective for taxable years beginning after December 31, 1996. The two-year holding period begins on the date of the grantor's death. A trust becoming an S corporation shareholder under a will is also permitted to be an S corporation shareholder for two years beginning on the date the stock is transferred to the trust. **Act § 1303, amending I.R.C. § 1361(c)(2).**

Financial institutions able to hold safe harbor debt. The bill allows financial institutions ("a person which is actively and regularly engaged in the business of lending money") to hold safe harbor debt ("straight debt"), effective for taxable years beginning after December 31, 1996. **Act § 1304, amending I.R.C. § 1361(c)(5)(B).**

S corporation terminations and elections. The legislation broadens the authority to treat S corporation election terminations as inadvertent and provides authority to treat

late elections as timely when there was reasonable cause for the failure to make the election in a timely manner. IRS may waive the effects of an invalid election caused by inadvertent failure to qualify as an S corporation or to obtain shareholder consent or both. **Act § 1305, amending I.R.C. §§ 1362(b), 1362(f).**

The provision is effective for tax years beginning after December 31, 1982.

Election to terminate year. The legislation clarifies the election to terminate the taxable year. If a shareholder terminates the shareholder's interest in an S corporation, for "affected shareholders" the taxable year may be treated as two taxable years the first of which ends on the date of termination. The term "affected shareholder" includes all shareholders to whom the terminating shareholder had transferred shares during the year. **Act § 1306, amending I.R.C. § 1377(a)(2).**

The provision applies to taxable years beginning after December 31, 1996.

Ownership of subsidiaries. The legislation allows an S corporation to elect to hold stock in wholly-owned subsidiaries provided the subsidiary is a "domestic corporation." The subsidiary is not considered a separate corporation. **Act § 1308(b), amending I.R.C. § 1361(b)(2).**

The provision is effective for taxable years beginning after December 31, 1996. **Act § 1317(a).**

Distributions during loss years. The legislation clarifies that, in the case of distributions in loss years, the stock basis is to be determined by including the adjustments from the loss before the loss limitation is applied for the year. Consequently, distributions reduce the basis for determining the allowable loss for the year. However, that loss does not reduce the basis for purposes of determining the tax status of the distributions. **Act § 1309(a), amending I.R.C. § 1366(d)(1).**

The provision is effective for taxable years beginning after December 31, 1996.

Accumulated adjustments account. The act clarifies that the amount in the accumulated adjustments account as of the close of the taxable year is to be determined without regard to any "net negative adjustment" for the year. That term is defined as the reductions in the account for the taxable year (other than for distributions) over the increases in the account for the taxable year. Net negative adjustments are disregarded. **Act § 1309(b), amending I.R.C. § 1368(e)(1).**

The provision is effective for taxable years beginning after December 31, 1996.

Subchapter C rules applicable. The legislation makes it clear that C corporation rules apply to an S corporation (including liquidation) except to the extent inconsistent with Subchapter S. **Act § 1310, amending I.R.C. § 1371(a).**

This provision applies to taxable years beginning after December 31, 1996.

Elimination of earnings and profits. The act provides that S corporations with elections for taxable years beginning before January 1, 1983, that are S corporations after December 31, 1996, are to have their accumulated earnings and profits reduced by accumulated earnings and

profits in any tax year before 1983 for which the corporation was an S corporation. The result is that an S corporation's accumulated earnings and profits are solely attributable to tax years for which its S corporation election was not in effect. **Act § 1311(b), amending I.R.C. §§ 1042(c)(4)(A)(i), 1362(d)(3), 1375(a),(b).**

Adjustment to basis of inherited stock. The legislation specifies that for stock in an S corporation acquired by reason of death or by bequest, devise or inheritance, the income-in-respect-of-decedent rules are to be applied as if the decedent had held the IRD item directly. The basis of stock in an S corporation at death is to be reduced by the portion of the value of IRD items attributable to the decedent. A deduction under I.R.C. § 691(c) is allowed for the estate tax attributable to an item of income in respect of decedent.

The adjusted basis of the stock acquired from a decedent is reduced to the extent to which the value of the stock is attributable to IRD items. **Act § 1313(a), amending I.R.C. § 1367(b).**

The amendment applies to decedents dying after the date of enactment. **Act § 1313(b).**

Real estate subdivided for sale. S corporations are made eligible for the special rules applicable to real property subdivided for sale (I.R.C. § 1237) that are available to noncorporate taxpayers. **Act § 1314(a), amending I.R.C. § 1237(a).**

Exempt organizations as shareholders. The legislation allows certain exempt organizations to be shareholders in S corporations with each to count as one shareholder. **Act § 1316, amending I.R.C. § 1361(b)(1).**

The amendment is effective for taxable years beginning after December 31, 1997. **Act § 1316(f).**

Basis Adjustment

If a taxpayer satisfies the replacement property requirement for involuntarily converted property by acquiring stock in a corporation, the corporation must generally reduce its adjusted basis in its assets by the amount by which the taxpayer is required to reduce its basis in the stock. If more than one piece of property is acquired, the basis is allocated in proportion to the respective costs. The taxpayer's basis in the corporation's stock is reduced by the amount of any gain from the involuntary conversion that was not recognized. **Act § 1610, amending I.R.C. § 1033(b).**

The amendment is effective for involuntary conversions occurring after the date of enactment. **Act § 1610(b).**

Spousal IRAs

Spouses without earned income are allowed to contribute and deduct up to \$2,000 per year to an IRA. Previously, if one spouse had no earned income, a married couple was allowed a maximum annual IRA contribution deduction of \$2250.

The spousal IRA rules apply if a joint return is filed and the amount of compensation (if any) includible in the individual's gross income is less than the compensation includible in the spouse's gross income. If the working spouse is an active participant in an employer-sponsored retirement plan and earns over \$40,000, the maximum amount of the deduction for the spousal IRA is reduced proportionately as under prior law.

SUMMARY OF SELECTED PROVISIONS HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT

(P.L. No. 104-191, signed August 21, 1996)

by Neil E. Harl

Health Insurance

The legislation increased the deduction for health insurance premiums for self-employed individuals beginning in 1997. The level of deductibility remains at 30 percent for 1996, rising to

- 40 percent for 1997
- 45 percent from 1998-2002
- 50 percent for 2003
- 60 percent for 2004
- 70 percent for 2005
- 80 percent after 2005

This change is important for farmers who have implemented or have considered implementing plans with the spouse as employee to obtain full deductibility of health insurance premiums. **Act § 311, amending I.R.C. § 162(l)(1).**

Long-Term Care Insurance

Amounts received under qualified long-term care insurance contracts are excludable from gross income under the legislation up to \$175 per day. This amount is adjusted for inflation after 1997.

The deduction for health insurance expenses (at the 30 percent level for 1996) applies to long-term care insurance premiums.

Employer-provided long term care insurance premiums are not excludable from an employee's income if provided under a cafeteria or other flexible spending arrangement. **Act § 321(a), adding I.R.C. § 7702B.**

The provision is effective for contracts issued after December 31, 1996. **Act § 321(f).**

Terminally Ill Individuals

Individuals who are terminally and chronically ill are allowed to exclude from gross income life insurance benefits paid out prior to death. A "terminally ill individual" is an individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of certification. **Act § 331(a), adding I.R.C. § 101(g).**

The provision is effective for amounts received after December 31, 1996. **Act § 331(b).**

IRA Withdrawals

Effective for distributions after December 31, 1996, the legislation allows penalty free withdrawals from individual retirement accounts for qualified medical expenses that exceed 7.5 percent of adjusted gross income, the floor for deducting medical expenses. Likewise, the 10 percent additional tax does not apply to IRA distributions for payment of health insurance premiums after separation from